

The Economy in Perspective

Money talks... Many analysts have been projecting a decline in the dollar's foreign exchange value for years now. Their logic seems to be that the U.S. trade balance, which has been in considerable deficit lately, "should" move toward zero, or surplus, and that dollar depreciation is a necessary part of this process. U.S. manufacturing companies, in particular, have been complaining that the "strong dollar" is an obstacle to profitability and that the U.S. government should take steps to weaken the dollar's value.

Considering that its exchange value is determined in international currency markets, it is no more meaningful to label the dollar strong or weak than to attach that label to wheat, copper, or semiconductors. Dollars become more expensive to purchase when people become more willing to exchange other foreign currencies for them than the other way around. It doesn't really matter why. One reason might be the purchase of U.S.-made goods; another might be the purchase of dollar-denominated assets. Regardless, the relative supply of, and demand for, a currency is what determines its exchange valuation.

Capital inflows accompany trade deficits. For every U.S.-based exporter whose products are more expensive abroad because of the dollar's exchange value, some U.S. firm or consumer is benefiting from lower interest rates. Arguably, U.S. exporters benefit from the strong dollar on the financing side of their operations at the same time as they suffer from the foreign price of their merchandise. For years, large capital flows into the United States enabled firms here to invest and households to consume at a brisk pace without having to generate a commensurate amount of domestic savings. For a share of the investment returns, the rest of the world has been bankrolling our consumption.

The U.S. manufacturing sector's long-term prospects will not be determined exclusively by its own managerial prowess, labor quality, or productivity; the rest of the world matters as well. U.S. industry, which has become increasingly efficient over time, contributes heavily to the nation's economy. But in a relative sense, the rest of the world is improving its manufacturing capabilities faster than the United States. This trend favors production of foreign goods and, by itself, reduces the demand for U.S. dollars. At the same time—as good as it already is—the United States seems to be improving its service-producing capabilities faster than the rest of the world. Among these are financial

services, which derive value from the integrity, reliability, and efficiency of the entire U.S. financial system. This comparative advantage strengthens demand for U.S. dollars. If both these trends continue, the U.S. manufacturing sector will probably shrink further over time, just as service-producing industries will probably continue to expand.

Even as countries debate dollarization, it has become a fait accompli in international liquidity and risk management circles. During the last decade, U.S.-based financial institutions filled the void created when Japan's financial institutions retreated from their formerly strong position and when the proposed European currency's success was problematic. In the 1990s, each time a currency crisis beset a regionally important country anywhere in the world, it became more evident that the U.S. dollar and U.S. financial markets play a pivotal role in global financial stability. We cannot know how much "demand for dollars" remains unfilled throughout the world, but if it is considerable, the dollar's exchange value could remain in its current range for a while. Immediate dollar depreciation is not inevitable.

Another point that advocates of a weak dollar often fail to recognize is that for the dollar to depreciate, the currencies of some other countries must appreciate. Which are the likely candidates? Without naming names, they would have to be countries with "undeservedly weak" currencies, presumably running trade surpluses, that would not mind watching their export sectors slow down. Very few countries are likely to volunteer.

Come to think of it, how could a country go about influencing its currency's exchange value? It would have to do something to affect demand for its currency, such as alter its inflation rate; its legal, accounting, and financial environment; its trade policies; or its productivity growth rate. Economic policies that alter a country's nominal exchange rate do not necessarily alter its real exchange rate in any meaningful way. History demonstrates that policies designed to reduce the foreign attractiveness of a nation's currency inevitably lower the living standards of its citizens. If and when dollar depreciation occurs, let's hope that it is driven by improvement in our competitors' economic circumstances and not by deterioration in our own fundamentals.

With this in mind, it would be fair to say that the greatest foreign exchange threat facing the U.S. economy is not the trending of the buck, but the bucking of the trend.